A8825-1

Securities Industry

TRENDS

An Analysis of Emerging Trends in the Securities Industry
Produced by the SIA Research Department

Vol. XVII, No. 2 May 15, 1991

"COST CONTROL & MANAGING FOR PROFITABILITY"

Highlights of

SIA's 1991 Trends Conference

Selected Speaker Summaries:

James R. Jones
Chairman, American Stock Exchange
"Opening Address"

Michael Goldstein
Investment Strategist, Sanford C. Bernstein & Co.
"Managing for Profitability"

Michael A. Keane
Manager, Nolan, Norton & Co.
"Improving Performance in the 1990s"

Sally Hernandez-Pinero
Deputy Mayor for Finance, City of New York
"Luncheon Address"

Robert H. Whitby
Partner, Ernst & Young
"Strategic Approach to Cost Restructuring"

Donald L. Calvin
Chairman, International Business Enterprises, Inc.
"Concluding Address"

Securities Industry Association
120 Broadway, New York, NY 10271 • (212) 608-1500 • Fax: (212) 608-1604
1850 M Street, NW, Washington, DC 20036 • (202) 296-9410 • Fax: (202) 296-9775
Annual Subscription: $60 member • $96 non-member • additional $12 outside of U.S. and Canada

"OPENING ADDRESS"

JAMES R. JONES
Chairman, American Stock Exchange

I'll open this Trends Conference by making three predictions on where the securities industry is heading in the 1990s. A company that wants to raise money around the world faces a wall of conflicting regulations. But now, the Europeans are bringing their accounting, listing and disclosure requirements into line. Prediction number 1: within five years, the U.S. will get on board, too. The major markets of the world will then have one set of rules that apply to major issues in major markets. A company seeking to raise capital in the U.S., Europe and Japan, will be able to do it all at once with documents that meet uniform standards. That's tremendously important because the market changes quickly and an opportunity delayed can be an opportunity lost. The result of uniform rules will be far smoother cross-national capital and ownership flows.

The Europeans have created an E-100 Index made up of 100 blue chip stocks in nine European countries. The Amex will trade warrants and options on the index, denominated in dollars. The MATIF (France) will trade futures denominated in ECUs. The European Options Exchange (Amsterdam) will trade options on the index, denominated in ECUs. The SOFFEX (Switzerland) will trade both options and futures, denominated in Swiss francs, and there are reports that both the Germans and the Swedes will participate.

We will have this pool of liquidity behind a common concept. Carry this concept one step further; prediction number 2. I can see a time when an investor looking to buy a stock can sit before a computer screen anywhere in the world and when the U.S. market is open, the investor can trade it in dollars; when Frankfurt is open, trade it in marks; when both are open, the investor can pick the best price in either market or any number of markets.

The system won't displace existing trading mechanisms; it will bring them together. The cooperative spirit exists to make that happen, especially in Europe. When will we see a 24-hour global market? I'll stay with my previous time frame, five years.

There is going to be a reduction in the number of independent markets now scattered around the U.S. There will either be mergers or other working agreements, or a number of markets will go out of business. The Germans followed this pattern in unifying Frankfurt's dominance over that nation's six smaller markets. Prediction number 3; again within the five-year period. The U.S. is likely to see not one but at least three prominent markets. The survivors will include auction markets and screen-based electronic markets, or hybrids. That's the end of the predictions. Now, I'll put them into context.

For decades, our industry was sheltered by regulations which kept banks in their place and foreigners off our exchanges. These rules restricted pension funds from investing overseas and limited competition among the markets. Overseas, the restrictions protecting exchanges and brokerage firms were even stronger.

However, that scenario is changing and change is a period of opportunity. But it won't be easy; there are obstacles.

Despite the ability of capital to flow across borders, protectionism isn't dead. When Europe '92 comes into being, it will have, at least initially, a protectionist undercurrent. Be that as it may, all of us are going to be in an international business in the sense that global events will affect our economic decisions as never before. This doesn't mean that you have to physically establish full-blown operations overseas, although some firms will take that step.

The American Stock Exchange looked at globalization and decided that neither we, nor any other market, had the resources to go charging overseas. Instead, we turned a potential weakness into a source of strength by forming alliances. We worked with Tokyo to obtain access to surveillance information from Japanese regulators. By January 1990, we were ready to launch trading in Nikkei warrants. Later in the year, the ties we developed also enabled us to launch options on an index of 210 Tokyo Stock Exchange stocks. During 1990, we followed the same approach in bringing warrants on the FT-SE 100 index traded in Britain. By November 1990, we were trading warrants on the CAC-40 index of 40 French blue chip stocks, while the Bourse traded warrants on the Amex's Major Market Index.

In each of these negotiations, the important factor was not simply the specific product we came away with. It was the *relationship* we developed. We want to get our listed companies onto foreign markets; to attract foreign investors to our new products, to open other business opportunities overseas. The key to this, in our belief, is relationships.

In this country, many business and government leaders realize that we need to create something like EC '92. We should be looking toward a North American free-trade zone which would represent a potential common market of 350 million people. There is a good deal of protectionist resistance to a U.S.-Mexico Free Trade Agreement, but we must get moving. Despite concerns about the Free-Trade Agreement with Canada, it is working so well that the two governments have decided to speed the introduction of new stages. Canada is our biggest trading partner. Mexico is our third largest and gaining, so we should broaden the Treaty to include Mexico.

Beyond this global picture, I think our industry must remember some fundamentals from the past. One is our responsibility to emerging and mid-sized companies. Without the new jobs, new opportunities and new thinking these companies provide, our society and economy will be diminished, and we will never be serious global competitors. The other traditional bedrock of our industry has been the individual investor. One of the exciting features of the market in recent months, was the reappearance of individual investors. Although they're constantly written out of our future, they refuse to vanish. Their participation is good for our markets and free-market economic system.

One final prediction. The U.S. has the most sophisticated, innovative securities people in the world. Therefore, buy a call, because I see a terrific decade ahead.

"MANAGING FOR PROFITABILITY"

MICHAEL GOLDSTEIN
Investment Strategist, Sanford C. Bernstein & Co.

If you compare surfing with Wall Street, the business wave of the early-to-mid-1980s was the "Big Kahuna." Similarly, October 1987's panic tidal wave of selling was the big "wipe out." Its aftermath left many battered brokerages on the rocks and others, totally submerged.

The securities industry is inherently unpredictable and volatile. If we look at the growth rate of net revenues (net of interest) over the decade 1980 to 1990, we see that it was 7.2% annually, on average. But, the standard deviation of this growth rate was more than twice as large, 17.6%, which, in statistics, is about as volatile as you can get. Similarly, although not as dramatic, the standard deviation of equity market returns about equalled the annual returns themselves, 14.0% and 14.7%, respectively.

But back to the "Big Kahuna" of 1979 to 1987. The volume growth over this period was 135% in bond turnover, 128% in stock turnover, and 191% in corporate underwritings. The growth in industry capacity is highlighted by a 96% growth in headcount combined with a 433% growth in industry capital.

Meanwhile, there was a countervailing force, in terms of industry profitability, at work during this period. Institutional equity commission rates fell 40% while debt underwriting spreads contracted a full 60%. In this aftermath came the "collapse," beginning in 1987. After 1987's first quarter peak, where the industry earned a record quarterly profit, to the end of last year (4/1/87-12/31/90), almost all industry parameters headed south. In volume terms, bond turnover fell 37%, stock turnover was down 24%, and underwritings fell 23%.

For capacity measures, only capital increased, 7%, but even here the trend was down after peaking at the end of 1989. Capacity, measured by headcount, fell 23%. The eroding margins in price which occurred throughout the 1980s continued during this contraction period. Institutional commission rates fell a further 10% and underwriting spreads a further 12%.

In just the past five years, the mix of business contributing to the industry's bottom line, and a shrinking bottom line at that, changed dramatically. Retail's contribution to profits altered dramatically. Retail's contribution fell from 21% of profits in 1986, prior to the crash, to 9% in 1988 and 12% last year. Traditional retail brokerage alone, where the vast majority of the industry's employment, physical plant and other efforts are concentrated, went from a mere 13% contributor to the bottom line in 1986, a good year, to a *consumer* of 10% of industry profits in 1988 and 1990. This basically nullified the profits from institutional sales and trading, itself under pressure. The saviour in retail was asset management, which climbed from 8% of total profits in 1986 to 22% in 1990, second only to proprietary trading as a bottom line contributor last year.

CONTRIBUTION BY LINE OF BUSINESS
(% of Net Income)

	1986	1988	1990
INSTITUTIONAL			
Sales & Trading	20	12	10
Underwriting	20	17	8
M&A/Advisory	20	31	20
Proprietary Trading	10	18	40
	70	79	78
RETAIL			
Brokerage	13	-10	-10
Asset Management	8	19	22
	21	9	12
OTHER	9	12	10
TOTAL	100	100	100
NET INCOME ($ Bils)	$3.8	$1.8	$1.0

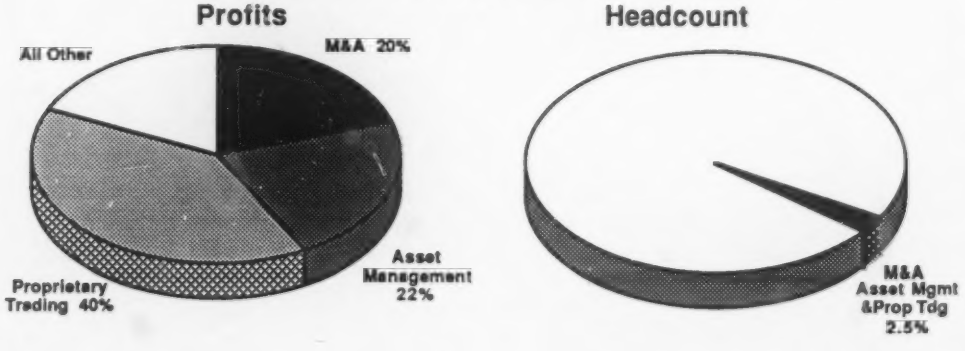
Most institutional businesses went through their own mid-life crises also. As mentioned, sales and trading was a 10% contributor to profits last year, half its 1986 level. We've seen earlier that institutional rates have fallen annually since deregulation in 1975.

The slashing of underwriting spreads, also shown earlier, combined with slow capital markets activity last year, led to a decline in these profits to only 8% of the total — again, a much smaller total to begin with, only one-quarter 1986's level. In actual dollars, last year's underwriting profits were only 10% of what they were five years ago.

M&A and other advisory fees have also been decreasing but are still around one-fifth of the industry's shrinking profit base. Only proprietary trading continues to generate between $300 to $400 million in annual profits, about $2 out of every $5 in profits last year, by far the biggest source.

This disequilibrium in the product mix contributing to profits is dwarfed by the disequilibrium in the workforce distribution earning these profits. As seen in the following chart, 82% of the profits in 1990 came from M&A, asset management and proprietary trading, while only 2.5% of the workforce is dedicated to these areas.

DISEQUILIBRIUM IN THE INDUSTRY — 1990



The payroll cost base (the largest non-interest expense of almost any firm), the infrastructure to support this workforce, etc. is 97.5% dedicated to areas only bringing in 18% of the profits! This support cost is important. While compensation per employee has grown 6% annually from 1980 to 1990, the growth rate for occupancy per employee has grown at more than twice that rate — 13% annually.

OCCUPANCY EXPENSE GROWTH HAS BEEN PROBLEMATIC

(Expense per Employee)

	1980	1990	Annual Growth
Compensation	$45,000	$82,000	6%
Occupancy Expense	$4,000	$14,000	13%

We saw earlier how institutional business profits and profit margins have been declining for years. The declining profits combined with the increasing costs of compensation and infrastructure can be devastating. These are areas where Wall Street can easily reduce costs.

The 500 largest institutional accounts (managing $1 billion or more) internally employ 8,170 portfolio managers, or about 16 per institution. Wall Street's institutional workforce, including support staff, numbers 50,000. That works out to a headcount of 100 each for these large 500 accounts or six times the number of portfolio managers being serviced. That's a lot of coverage for a not so profitable business line.

Firms have tried to respond by expanding their institutional business from a transactional business (trading) to bundled services such as asset management, trust services, clearance and custody, arbitrage and high net worth brokerage. They've moved more and more towards proprietary arbitrage, used institutional infrastructure to service wealthy individuals, and used their international expertise to penetrate emerging markets.

Other winning strategies will be the integration of the retail distribution network with asset management; further domestic and foreign risk taking through arbitrage and proprietary trading, and dominance in corporate financing relationships.

Areas for further cost control include: de-emphasizing further horizontal or vertical integration which rarely works; outsourcing; using ownership as a key element of compensation; monitoring support ratios and unit costs much more carefully; and watching for price competition, which is inevitable. Plan for it!

"IMPROVING PERFORMANCE IN THE 1990s"

MICHAEL A. KEANE
Manager, Nolan, Norton & Co.

Current approaches to performance measurement are becoming obsolete and may be interfering with our ability to move into the future. The financial services organization of the 1990s should emphasize factors such as quality, excellent service, and response time, as well as financial performance.

Today's securities firm is being squeezed by pressures to reduce costs and to do more with less. As usual, Operations, the back office, tends to take the first and most comprehensive hits. That tendency to slash causes a reduction in service levels and quality, but doesn't necessarily create improvements in the way we do business. Yet in spite of all the cuts in Operations, these are only about 15% of a firm's total costs. Obviously, for most firms, there is very little left to cut in Operations without adverse effects on service and support levels.

To manage costs and measure performance in the 1990s, we have to continue to look at financial measures. But, in the face of global competition, we will also have to measure other key factors which differentiate us from our competitors, factors which other industries have emphasized as a means of ensuring survival.

We need to look at how much time the firm needs to develop, sell, and distribute new products. We need to know how long it takes to develop, market, and support a new product, both in terms of personnel and technology. This is equally important for the innovator and the follower. If I launch a new product or service, I want to gauge how long it will take to do so fully, in order to understand my real advantage over the competition. If I am the competition, I want to know how long it will take to copy the product or service, to determine if I can be in that game or not. You must also know the knowledge of your people: chart it, develop it, and surround it with support technology to help move fast and take advantage of changing opportunities.

Those two factors together help constitute the firm's ability to innovate, learn, and change. Knowing how quickly we can change or upgrade skills and support systems tells a lot about our collective learning rate. In the information organizations of the 1990s, that may become the only sustainable competitive advantage. We need to look carefully at customer satisfaction. We need to be sure that our internal business processes, especially those that impact customers, are smooth, logical, up to date and not just an inheritance from the way we used to do things. In sum, we want a balanced business scorecard to account for the well-known factors we always monitored but also to chart our performance in significant areas of service and performance where previously we might have operated on word of mouth or wrong assumptions. How do we measure performance to the customer?

Time — how quickly and effectively do we satisfy our customers? Do we respond appropriately to their needs? If they want a product or service available at another firm, how rapidly can we create the same product? Once created, do we service it and support it and them well, or do we content ourselves with mediocre service?

Quality — how good and rapid is our decision making, either for customers who depend on our advice or for the risks we take as a firm? How quick do we get information to our customers, including internal customers, i.e. another department? How accurate is that information?

Service — take the pulse of the customer to find out how we are doing in terms of responsiveness, accuracy of our information, quickness to market, quality of services and products. You should measure your performance in this area against "world-class" competitors; even go outside the industry and take the best ideas from others to improve the customer's view of you.

Many organizations today are taking responsibility for portfolios of business processes, or portfolios of systems applications, in the same way they are responsible for securities portfolios. Identifying the 6 or 7 key processes, measuring our performance on them, and finding ways to improve them, are key to managing your business in the next decade.

Are we able to sustain innovation, change, and improvement? Indicators of market innovation can be revealing. Some firms are constantly innovating and generating revenue from new products. Others follow and fall behind. Do we really know our score? Do we know how long it takes to improve performance in a given area — how long to decrease errors, improve responsiveness, decrease response time? Do we know how good we are at gathering our intellectual assets, the best and the brightest, the collective expertise and experience of the best brains in the firm and making that expertise and experience available to other employees to get them up the learning curve more quickly and hasten their productivity?

What drives the scorecard? Executive management must emphasize the importance of all these perspectives to the health of the firm, and management must be hands on and "have skin in the game." Employees must understand and be committed to the strategy, to the customer, and to a never-ceasing search for better ways to work. They have to be encouraged to broaden their skill base through rotation and cross-training. We cannot afford to have employees spend 20 years in muni clearance; we need to develop them beyond that. The danger is that the 20 years becomes one year of experience repeated 19 times. You have to establish team-based accountability and you need to reward team-based performance that crosses over departmental barriers. The bedrock for this scorecard is the strategic use of information technology to supply the executive information systems that measure these factors.

This scorecard may be somewhat unconventional for our industry but I am confident of its value for gauging our continued success potential, our longevity, and our profitability. It talks about getting things right so that our ability to develop products and markets, support what we are selling, and keep our customers happy, is certain. I am confident that if we do those things right, the financials will work out right. Continue to measure the financials in your striving to manage costs and increase profitability, but insist on good measures of your customer's perspective, your organizational learning, and your processes, to balance out your scorecard.

"LUNCHEON ADDRESS"

SALLY HERNANDEZ-PINERO
Deputy Mayor for Finance, City of New York

Over the years, SIA and New York City have built an important and symbiotic relationship. We also often follow each other's leads and attitudes. The theme of this year's conference, "Cost Control and Managing for Profitability," proves once again that the industry and New York are thinking the same way.

Some analysts call this current economic climate a "cyclical downturn;" others call it a "market contraction." I call it tough. The recession began in and hit hardest upon our financial services and securities industries, the very firms that fueled much of New York's growth during the last decade. From 1980-87, more than 115,000 jobs were added in financial services, representing 40% of the City's private job growth. Since the crash, more than 50,000 jobs have been lost in the industry.

Our success will depend on how we meet immediate fiscal and managerial challenges, and how we balance that with investment and planning for tomorrow's climates. During an economic recession, the clock does not stop ticking — we must keep looking ahead. In New York, we are taking the difficult steps toward living within our means. But we're also working to ensure this City is the most competitive and attractive in the world, to stay the "Capital of Capital."

Throughout last year, we controlled our budget by balancing it and we shall do so this year and in the years to come. New York will spend no more than what it earns. Through these economic trials and transitions, the health of the securities industry remains a priority. A more profitable industry means more tax dollars for the City, and more jobs for our workers. I recently created a new economic development "think tank" — the Industry and Commerce Group — that allows us to further explore areas of specific concern to you. For example, as high tech and computer automation become the norm in financial information technology for the 1990s, there is no reason why New York cannot set the world standard for making trades faster and less expensive to process. This is why I personally have been so supportive and enthusiastic about the new Securities Industry Automation Corporation facility in the Metrotech Center in Brooklyn. SIAC is the ideal example of the kind of competitive planning and investment the City and the securities industry can do together. It is among the most advanced facilities in the world for information and communications.

Computerized trading technology is here to stay, and it is expanding your jobs from a regional and national view to an international horizon of securities transactions and money flows. You need to be in a center where this information can flow freely and reliably. The last thing you need is disruptions in your network. This is why our Department of Telecommunications and Energy has joined with industry leaders on the Mayor's Task Force on Network Reliability that was formed even before the disruptions on Wall Street last fall. The Task Force works on preventing such disruptions, and if something does occur, it will make sure an effective contingency plan is in place.

Advanced information technology naturally means increased financial innovation in the securities markets. It means finding new ways of trading capital, using different methods and offering different kinds of capital products. New York should be at the very core of this financial innovation and a core of bright ideas requires a corps of bright people. The Board of Education's Academy of Finance trains our young people for entry-level jobs, it builds this cadre of bright and talented workers and keeps our city on the leading edge of financial creativity.

Yet, innovation in the securities industry can be, and has been at times, threatened by burdensome and ineffective legislation at different levels of government. Last fall, the federal government toyed with the idea of a securities transaction excise tax. This tax was a dagger pointed directly at the securities industry and at New York. Mayor Dinkins and City Hall lobbied intensely, and successfully, with industry officials to persuade Congress and the Bush administration to abandon this dangerous proposal, which would have crippled our already fragile economy.

Mayor Dinkins appointed a committee on Global Competitiveness to analyze those factors that inhibit the international competitiveness of New York's banking, securities and insurance industries. And when New York City goes to market, we have two new strategies that help us prove that New York is the best investment around — outreach and diversification. Outreach to the securities and investment community with our message that the Big Apple offers unparalleled security as an investment. We don't do magic with our budgets, we adhere to quarterly budget balancing using GAAP. We meet with investors and rating agencies to show how we close budget gaps thoughtfully and carefully.

For diversity, we constantly look to develop new institutional and retail buyers both in New York City and outside. Expanding the market for New York bonds lowers the overall cost of the debt that we must raise to invest in the infrastructure that is the foundation of our future. We're also diversifying the credit structures to offer better products to New York investors. We are looking for new ways to enable entities, such as Health and Hospitals Corp., to issue debt. A variety of credit structures means a more efficient and targeted investment for the buyer.

And finally, we're diversifying our loan structures, with instruments that provide flexibility, such as variable rate bonds or zero-coupon bonds. Just recently, the City successfully sold its first-ever variable rate bonds. The bottom line to all of this is better cost management and creative management. We have learned much of this creativity from many of you in the securities industry.

Because managing for profitability in the 1990s will be remarkably different than it was in the 1980s, we're going to have to work hard to stay ahead of the competition, whether from Los Angeles or London. Our history of working together gives us an instant edge in this game of global markets. Our immediate challenge is to keep the edge and our longer-term challenge is to expand this edge. We have created new partnerships with the securities industry that will do just that.

"STRATEGIC APPROACH TO COST RESTRUCTURING"

ROBERT H. WHITBY
Partner, Ernst & Young

First, some of the securities industry's results last year. Revenues declined in 1990 for the first time since the 1970s. The declines were felt across most product lines including: commissions, underwriting, repos and reverse repos, mergers and acquisitions, and private placements. Expenses decreased last year but less than the proportionate revenue decrease. The industry showed a net loss of $162 million, pre-tax, the first annual loss since 1973. What are the implications? Here are a few:

- The entire industry — not just some firms or products — is having trouble.
- Volume declines and the disappearance of entire markets (e.g., junk bonds) have created *substantial, structural overcapacity* in the industry.
- As the number of firms has declined, total capital in the industry has increased. Achieving economies of scale requires more capital than ever before.
- Further economies of scale will require still more capital. New capital can only be attracted to the industry when opportunities for profitability are restored.
- The recent increase in volumes and pre-tax profits in the first quarter of 1991 provides firms with much needed capital to fight growing cost pressures. However, this cannot be the standard method of approaching cost pressures.
- Industry solutions will require:
  - Industry capacity reduction;
  - Recognition that there will be few global and few full service players;
  - Strategic re-focus into areas of competitive advantage, with withdrawal from "also-ran" activities and from "overextending;"
  - Strategic cost restructuring, firm by firm.

Within the context of these solutions, I will highlight the methods for achieving strategic cost restructuring. But this must be accomplished with a realization of the other problems and solutions the industry faces. There are three basic steps to cost restructuring, with the first steps being the most effective. These are:

Step I: Analyze & Restructure Business Portfolio
Step II: Cost Re-Engineer Selected Core Businesses
Step III: Block and Tackle — Basic Cost Reduction

The first step is one which is conducted by the CEO and senior management and where 40% to 50% of total savings can be achieved.

Step I: Analyze & Restructure Business Portfolio

- Review and classify all businesses;
- Separate core businesses from non-core;
- Develop a screening process employing basic economic hurdles and apply to all businesses (ROE, capital risk, profit, volatility, etc.).

For example, ABC Securities, Inc., has several sub-businesses. After evaluating these businesses, separating them into core and non-core, and screening each to see if they make certain basic economic hurdles, ABC segments these businesses into four categories: non-core that fail the hurdles, non-core that make the hurdles, core that fail, and core that make the hurdles. The following actions should then be taken.

Non-Core — Fails Hurdles:
- ☐ Liquidate.

Non-Core — Makes Hurdles:
- ☐ If possible to sell at a premium: *Divest*
  - — Realize capital gain
  - — Redeploy firm capital into core businesses.
- ☐ If not possible to sell at book value or better: *Retain*
  - — Protect earnings stream
  - — Avoid taking a capital hit.

Core — Fails Hurdles:
- ☐ Give management 60 days to develop a plan for passing hurdles;
- ☐ If plan is acceptable, support its immediate implementation;
- ☐ If plan is unacceptable,
  - — Re-define as a non-core business
  - — Downsize or liquidate.

Core — Makes Hurdles:
- ☐ Keep businesses and evaluate for cost reduction opportunities.

Step II: Cost Re-Engineer Selected Core Businesses

The objective of Step II is to fundamentally re-engineer a selected few core businesses to achieve a significant cost reduction of 40% to 50% in the corresponding cost structures. Such opportunities may present themselves in only 10% to 20% of your core businesses. Even so, you should expect to realize 30% to 40% of your firm's total cost savings opportunities from cost re-engineering these selected activities.

First, look at opportunities for reducing costs *significantly* in the remaining portfolio of core businesses. Consider possible synergies and economies of scale in your current portfolio of core businesses. Challenge the corporate framework — do not look only for savings of 10% to 20% across the board; look for radical, significant cost savings, consolidations, and entirely new ways to approach the business.

Review the total cost structure, both fixed and variable, of each core business and conceptualize methods for re-engineering this cost structure to *significantly* reduce

total costs. Ideas may include: merging activities; introducing technology (e.g., image processing, telecommunications networking); outsourcing, or moving operations to a third world country to save on labor costs. Obviously, this last point might be a little radical for a securities firm (however, across the Hudson is not), but the idea is to really rethink the cost structure, to challenge the corporate framework. Only in this way can one find *significant*, 40% to 50%, cost savings opportunities.

Next, is the process. Elicit ideas from top management and remember to challenge them. Present the same challenges to independent consultants. Then, combine all re-engineering plans and conduct a management forum to choose the most viable plans and implement them. Devote your full energy to these chosen strategies where the possibilities for success are the highest. In this way, you can achieve *permanent* cost reduction that will yield *competitive* advantages.

Step III: Block and Tackle — Basic Cost Reduction

Unfortunately, this step is often the first, and sometimes the only one firms take. However, it is where you achieve the least cost savings of all three steps. It involves streamlining operations and eliminating waste. You should evaluate your activities to determine which add value to the process and ultimately, to the product. Techniques may include "activity based cost management," "process value analysis," "capacity management," and other efficiency management tools. Use of these techniques can provide management with: better understanding of the causes of an activity; analytical means with which to monitor process performance, and, ultimately, the necessary insight to *do it right the first time!*

When all else fails, you can mandate a universal reduction of 10% to 20% of activity in those areas that are deemed the least productive. But remember, 40% to 50% of cost reduction will be obtained in Step I, the business portfolio restructuring conducted by the CEO and senior management. An additional 30% to 40% can be found in Step II, process re-engineering conducted by middle management. Only 10% to 20% of total savings can be found in the block and tackling mode.

"CONCLUDING ADDRESS"

DONALD L. CALVIN
Chairman, International Business Enterprises, Inc.

A quick trip around the world for developments on the Conference theme — profitability.

London — The profits of Nomura for the first six months of its current fiscal year are greater than the combined profits of all U.K. firms for *full*-year 1989. Meanwhile, Nomura's current fiscal year is its worst in a decade while 1989 was the *best* year for U.K. firms since 1986.

Problems in London

1. Overcapacity - too many firms chasing too few customers.

2. Over-optimism; firms were convinced that London would become *the* world financial center. In a dose of reality, the "International Stock Exchange of the United Kingdom and the Republic of Ireland" is changing its name back to simply the "London Stock Exchange."

3. A lack of planning; firms believed it was possible to "muddle our way through to profitability."

4. Large problems of changing regulatory and business environments, i.e. a new "Financial Services Act," four self-regulatory organizations, the SIB, the DTI, etc.

5. The local U.K. retail business has mainly been dependent on government privatization (British Telecom, British Water, etc.), which is transient.

6. A key to growth and profits was to attract international business to London, especially in non-U.K. stocks. The success of efforts to attract trading in foreign stocks to London appears to have already peaked. Why? European exchanges are now more competitive. Amsterdam, Paris, Brussels, and Switzerland have all taken recent actions to attract and keep business in their home markets. Sweden has been the exception. This is because of the Swedish stock transfer tax and allowing investment outside Sweden.

Developments in Japan

The profitability of major firms in Japan has been down 60-90% this past year. Still, Nomura made nearly $3.4 billion for the fiscal year ended March, 1990. By contrast, in 1986, the best year ever in the U.S., total profits for *all* NYSE firms reached only $5.5 billion Even with a 60% decline in profitability, Nomura had $1.5 billion of profits for the year ended March 31, 1991. By contrast, NYSE member firms *lost* $162 million in 1990.

Japan has fixed commission rates and most business is retail. Securities commissions account for 41% of Nomura's worldwide revenues compared to 15% for Merrill, 2% for Salomon and about 16% for all U.S. firms in aggregate.
Some recent events in Japan:

1. From January to August 1990, the Tokyo Stock Exchange declined 40%.

2. Average daily volume on the TSE in 1990 was down 70% from 1989.

3. Volume hit a high of about 1.5 billion shares a day in 1989 followed by a low in January 1991 of 175 million; volume is now back up to one billion for some days in February.

4. A key market factor has been the rise in Japanese interest rates from a low of 3% to about 8% early last year.

5. The decline in the real estate market has dried up real estate lending, which had been used to finance stock purchases in the past .

6. Retail customer came back in the market in February 1990, right after a January decline, just in time for a 40% further decline in values. As a result, Japanese money moved into the Japanese bond market and out of the U.S. fixed income market *and* U.S. equities.

7. U.S. firms, on the other hand, had their best year in Tokyo in 1990. The reason, in one word, is "derivatives." Hedging with financial futures in Tokyo began in the Fall of 1988, followed by index options in 1989, and arbitrage between the cash market and the NIKKEI 225 futures traded on the Osaka Stock Exchange, etc. Some, maybe many, Japanese blame the U.S. firms and their program strategies and derivatives for causing the collapse of the Japanese stock market.

One big question in Japan — when will the Japanese retail customer return? Sound familiar? Japanese firms are calling for a return "Back to Basics," i.e. selling to the retail customer. Nomura has some 4,400 retail brokers plus some 2,900 saleswomen (selling to Japanese housewives) concentrated on this effort.

Finally, competition between Japanese banks and securities firms are bound to heat up as Article 65 Glass-Steagall type restrictions are changed. Large Japanese banks are getting into the securities business worldwide.

Developments in the U.S.

The good news is that stock market volume is back. Average daily volume in February/March was more than 1987's record 189 million shares per day on the NYSE; 1991 may be a record year in terms of stock market volume. The economy in the U.S. may improve while getting worse in Japan, Germany and Europe, generally. Regulation, *over*-regulation, in the U.S. is a major cost and competitive problem for U.S. firms and institutions trying to compete with non-U.S. firms.

Summing Up

What does all this mean for U.S. firms trying to operate profitably outside the U.S.? There are a lot of lessons here, but I'll mention only some of them. First, the business culture is different from country to country. Therefore, you *must* understand the business culture before 1) even considering opening an office, or 2) doing any business by telephone or personal visits, or 3) dealing with local firms overseas.

Second, if locals can't make money, foreigners can't either, especially if they try to compete with locals. This is a hard lesson learned by U.S. firms in London. Third, as U.S. firms have done in Tokyo, firms must use the expertise they have developed which the locals don't have. Therefore, doing business overseas is an area of specialization. You cannot expect to do business the same way in Germany as you do in the U.S., or in Japan or London, for that matter.

Finally, the days of the worldwide "financial supermarket," which was the talk of the early 1980s, are gone for all but a very small number of firms. Interestingly, large Swiss and Japanese banks seem to be still pursuing the worldwide financial supermarket strategy.

In sum, do business overseas (or with foreigners) only in those areas where you can reasonably expect to be profitable; you cannot expect to operate profitability overseas in areas where you can't do so locally.

Edited by:

George R. Monahan
Director of Industry Studies